Ethical Issues in Multilevel Marketing: Is It a Legitimate Business or Just Another Pyramid Scheme?

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Because of their inherent interest in marketing, students in marketing and sales classes are often approached by those attempting to recruit them to become involved in multilevel marketing programs. When students are presented with such a business opportunity, they often turn to their marketing professors for advice. Marketing educators need to be able to help their students differentiate ethical, legitimate business opportunities from those that are not. The current paper presents five questions students should ask when trying to ascertain the ethical and legal legitimacy of a multilevel marketing opportunity.

Marketing educators are seen by their students as experts. When they have a question regarding a marketing issue, students often turn to professors for answers. A common question they may ask advice on is multilevel marketing. A student may come up after class or visit a professor's office and ask advice regarding the "business opportunity" someone has just shown them. They could be asking about anything from an illegal pyramid scheme that is about to be shut down by federal regulators to a legitimate and highly respected company with great products and millions of loyal customers.

All marketing educators need to be able to give students advice that will help them avoid unethical and/or illegal business activities. However, as has been pointed out by Vander Nat and Keep (2002), some of these unethical/illegal marketing scams have many of the same characteristics as legitimate multilevel marketing organizations. On the legal side, things are not black and white. Sometimes it is a challenge for regulators to deal with companies that operate in the gray area.

Even if a company is fulfilling its legal obligations, that does not mean all its practices are ethically correct as legal does not necessarily mean ethical. There are practices that occur within multilevel marketing that, while not being technically illegal, may be ethically questionable. Also, most of those involved in recruiting representatives for multilevel marketing are independent contractors and not employees (Vander Nat and Keep 2002). Though a multilevel marketing organization itself may not be illegal or unethical, a particular recruiter may engage in unethical or illegal practices that are not acceptable by the standards of the company they represent.

The current paper discusses ethical and legal issues in multilevel marketing. The article begins with a brief overview of multilevel marketing and some of the problems the industry faces. It then discusses why marketing educators need to be able to give their students fair, educated guidelines capable of differentiating legitimate marketing opportunities from ones that are not. Finally, it discusses five questions that students should ask that will give them simple yet practical advice when trying to determine the legitimacy of a multilevel marketing opportunity.

The Multilevel Marketing Industry

Peterson and Wotruba (1996) define direct selling as "face-to-face selling away from a fixed retail location" (p. 6). Direct selling refers to the way a firm contacts and executes business with their customers. Not all direct selling is multilevel marketing. However, within the direct selling industry, there is a common type of compensation plan that is used by many of the leading companies. Sellers are compensated not just for the sales they personally generate but for the sales generated by the people they recruit. Because those involved are compensated down through multiple levels of recruits (i.e., those they recruit, those their recruits recruit, etc.), this type of direct selling is often called multilevel marketing. The recruiting is usually done through personal networking; thus, multilevel marketing is also sometimes refered to as "network marketing."

Multilevel marketing is a huge, global industry. Estimates of worldwide sales are as high as ninety billion

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dollars (Dyer 2001). Estimates of the number of people who purchase products and services from multilevel marketing organizations are high, with one study finding that over half of the respondents had purchased at least one item from a multilevel marketing company (Kustin and Jones 1995).

The industry appears to be growing. Unfortunately with the growth of the industry has been the growth of questionable companies and practices. Vander Nat and Keep (2002) note that the FTC prosecuted more pyramid schemes in the years from 1996 to 2002 than in the previous seventeen years combined. The Better Business Bureau has warned that illegal pyramids are prevalent and widespread throughout the United States. Not only are there potential legal problems, multilevel marketing as a whole has a negative image among many consumers (Kustin and Jones 1995; Msweli and Sargeant 2001; Raymond and Tanner 1994; Peterson, Albaum, and Ridgeway 1989). It should be noted, however, that this negative image of multilevel marketing is not universal (Gabriel 1993). Many people are strongly in favor of multilevel marketing and show preferences for products or services that are distributed through such marketing channels.

Giving Good Advice

When students ask about a multilevel marketing opportunity, they are asking about a company that is in an industry with a history of legal, ethical, and image problems. If this is the case, why not just tell students to avoid all such marketing opportunities? Why not just paint the whole industry in a negative light as some educators have done (see, for example, Bloch 1996a; Bloch 1996b)? There are many good reasons for not doing so.

First, doing so perpetuates misinformation. It implies that all firms in this industry are bad. Pronouncing guilt by association is questionable. Prejudging all companies in an industry because there are problem companies in that industry is wrong. Marketing educators should be more sophisticated in evaluating the validity and ethical practices of a given firm rather than simply drawing conclusions based on instances that occur in the whole industry.

Second, it misses an opportunity to help students develop the ability to differentiate legitimate marketing practices from unethical ones. Marketing instructors work hard in classes to assure our students that, even though some advertisers are unethical, advertising itself is not unethical. Students need to be able to evaluate advertising ethics on a case-by-case basis. Likewise, sales classes help students understand that, even though some salespeople are unethical, sales itself is not unethical. It is crucial to teach students how to deal with ethical issues in sales so that they can make ethical decisions in the situations they may face should they enter the field of sales. Students must learn to use ethical heuristics that are more sophisticated than "they're all crooks." Marketing educators undermine their own credibility when they use such crude heuristics when asked to evaluate multilevel marketing opportunities.

Third, multilevel marketing represents an industry which provides a useful economic and business function. Direct selling seems to fill a legitimate need in the marketplace. Through direct selling, marketers can get significant amounts of information out to consumers in ways that are not feasible using traditional advertising or retail distribution. Advertising can only convey a limited amount of information and the staff of a typical retail store has limited information about the multitude of products being stocked. Thus, using traditional promotion and distribution channels, marketers may have a difficult time communicating large amounts of information. Often, companies will use direct selling to fill the gap.

Because of direct selling's ability to communicate large amounts of information, there are two types of products that seem best suited for this type of marketing. First, there are highly innovative products. For example, when home water filtration devices came out, they were distributed primarily through direct sales. People were not likely to go to their local variety store and purchase an attachment for their water faucet that would have cost them several hundred dollars. They could not even see the particles that these filters were eliminating. Consumers began purchasing them when companies started using direct selling to bring these filters into homes, demonstrate how they were used, and explain their benefits. Home water filters may never have gained acceptance if it were not for the direct selling industry. Direct selling is often the industry through which new and innovative products are introduced.

Another category of products that benefit greatly from direct selling are products that require greater information to see their benefits. Modern multilevel compensation programs can be traced back to 1941 and the Nutrilite company (Biggart 1990; Poe 1994). Nutrilite's founder Carl Rehnborg believed that nutritional supplementation was important. Though most medical experts today would agree with Rehnborg, it was very controversial in his day. Not only that, Rehnborg also believed that nutritional supplements made from natural sources were superior to those synthetically derived. Modern science is proving Rehnborg correct on this point, too. Carl Rehnborg was way ahead of his time. He needed to get out a lot of information in order to sell his natural nutritional supplements when they were competing against much cheaper synthetic alternatives. He found that the most effective way to educate consumers on the benefits of supplementation and on the advantages of natural supplements over synthetics was through direct selling. He found that the best way to recruit salespeople was to compensate existing salespeople when they recruited new salespeople. This was the birth of multilevel marketing as we know it today. It did not grow out of some unethical marketer trying to milk money from people through a pyramid scheme. It came from an innovative scientist and entrepreneur who needed to find a way to get as much information as possible out to as many people as possible.

So when students ask us about a multilevel marketing opportunity, they are asking us about something that must be evaluated on a case by case basis. It is extremely important that marketing educators be able to help students differentiate ethical direct selling organizations from unethical get-rich-quick scams and/or illegal pyramid schemes. However, since so few marketing educators have ever studied or been involved in this industry, most are inadequately prepared to do so. There are some papers that focus on legal distinctions. For example, Barkaes (1997) presents an overview of the pivotal Webster v. Omnitrition case (9th Circuit 1996). Vander Nat and Keep (2002) present a mathematical model to differentiate legitimate multilevel marketing from pyramid schemes. Papers such as these are excellent for helping wade through the legal nuances of regulating the multilevel marketing industry.

However, they are inadequate for providing practical guidelines for students when evaluating a business opportunity. Few students are willing to wade through legal briefs or work out complex mathematical models to try to figure out whether or not the opportunity they are looking at is legitimate. Also, these papers focus narrowly on the legal issues and not on the broader ethical issues. What students need, and what professors need to be able to give them, is simple guidance that will help explain the difference between marketing opportunities that are ethical and legal and those that are not.

So what is the difference between a legitimate marketing opportunity and an illegal or unethical one? This paper proposes a five-part test that marketing educators can give to students when asked about that "marketing opportunity." These guidelines are framed in the form of five questions the student should ask.

Question 1: How Is the Money Being Made?

Legitimate multilevel marketing companies compensate their salespeople for selling products or services to ultimate consumers and not for simply recruiting people. This is the primary distinction between a legitimate direct selling opportunity and an illegal pyramid scheme. In the Webster v. Omnitrition case (9th Circuit 1996), this distinction was presented as the sine qua non of legitimate marketing.

In a pyramid scheme, representatives are paid for recruiting not for selling products or services. For example, say I am recruited into a plan where every recruit pays a fee to get involved and that fee is used to pay people for recruiting. I may join a company for $200. Everyone I recruit must also pay $200. Let us say I get paid $50 down to three levels for each recruit. That means I get paid $50 for everyone I recruit (first level), $50 for everyone they recruit (second level), and $50 for everyone that people on my second level recruits (third level). The company takes $150 of the $200, pays the three levels of recruiting, and then keeps $50 for running the scheme. Notice that no products are being moved. People are just making money for recruiting. This is illegal and any operation such as this must absolutely be avoided. As soon as it is discovered by the appropriate regulating officials, it will be shut down.

Let us contrast the above with a legitimate marketing opportunity. In the best case scenario, there would be no incentive whatsoever for simply signing someone up. The only money that would be made would come from actually moving products once the person becomes involved. So, for example, say a person who signs up must pay $100. For that $100, the person gets some literature and product sample. In the cleanest case, neither this person's sponsor nor anyone in this person's line-of-sponsorship will receive any compensation on this $100 sale. It is only when the person takes the marketing tools and uses them to move products that anyone gets compensated. That is the cleanest example. No money is made whatsoever when people are signed up. Money is made only when the person moves products.

In the world of multilevel marketing, things are not always that clean. The previous examples are actually the two anchor points on a continuum from the clear pyramid scheme (first example) to a marketing opportunity that is clearly not a pyramid scheme (second example). Many unethical (and perhaps illegal) pyramid schemes are not as bad as the first example, and many legitimate and even highly respected marketing opportunities are not as clean as the second example. There is a lot of gray area between these two extremes.

The gray area is there because of inventory (for a discussion of inventory issues in multilevel marketing, see Croft, Cutts, and Mould 2000). To be an effective representative for many direct selling companies, a person must carry inventory. In theory, this inventory will eventually be sold to customers. However, it must be purchased before it can be sold. The person's line of sponsorship legitimately deserves to be compensated for this inventory moving through the organization. It is difficult for a direct selling company to compensate independent salespeople when the inventory is sold to customers rather than when it is purchased for inventory. The only feasible time to compensate the sales representatives is when they purchase the inventory from the company.

It is easy to see how this can create a problem. A firm may only require a small fee for a representative to get started but the person is sold a huge quantity of inventory. Firms can slip into ethical problems where more money is being made from the inventories being sold to new recruits than is being made from legitimate sales to bona fide customers. In the direct selling industry, there are terms that are used for this unethical practice. It is called either "inventory-loading" or "front-loading."

It must be noted that it may not even be the direct selling firm itself that is guilty of front-loading. It may be the people who are recruiting new representatives who are padding their pockets by encouraging these new recruits to purchase excess, unneeded inventory. However, legitimate firms do have policies in place to prevent front-loading.

So how can a legitimate direct selling firm combat front-loading? Actually there is a strong legal precedent for the best way to do so. A landmark case that established multi-level compensation plans as legitimate business enterprises was the FTC's review of Amway in 1979 (93 FTC 618). Two of the key policies that Amway had in force that seemed to have swayed the review that Amway was a legitimate business practice were their buyback policy and their inventory sales policy. In particular, Amway had a policy that it would buy back unsold inventory. It also required that 70% of the inventory a distributor purchased in any given month must be sold in the month it was purchased. Thus, sponsors could not make money by loading up their distributors with inventory and distributors would not be stuck with a lot of unsold inventory.

Most legitimate opportunities have policies that combat front-loading. However, as uncovered in the Webster v. Omnitrition case (9th Circuit 1996), even though a company may have policies consistent with those in the Amway case, they may not enforce them. Legitimate multilevel marketing firms have a buyback policy that is enforced. In the Direct Selling Association's Code of Ethics, member companies are required to repurchase, on commercially reasonable terms, inventory of independent salespeople when the relationship is terminated. The avoidance of front-loading is a legal responsibility as well as the ethical thing to do.

Based on the above, when students ask about a direct selling business opportunity they are considering, the first thing they should be encouraged to look at is how the money is being made. If money is made by recruiting, then the opportunity should be totally avoided. If the student is being encouraged to purchase excessive inventory, then this is also a sign that the opportunity may not be a legitimate, ethical enterprise. If some reasonable amount of inventory is required or encouraged, the student should look at what the company's buyback policy is. They do not want to be drawn into a scheme where money is made from recruiting rather than the movement of products.

Question 2: Are the Products Legitimate?

Students should ask themselves if the products they will be selling are legitimate products. Will they be able to benefit the lives of the people who buy them or will they have to push low-value products on friends and family in order to receive compensation? A classic test for a pyramid scheme has been known as the Koscot test, named after the case of Koscot v. FTC (1975). The rule is that, to avoid being considered an illegal pyramid scheme, compensation must be based on sales to ultimate customers. Because of this, almost all the opportunities require the movement of some products.

An unethical scheme trying to pass the Koscot test might operate like this. People are required, or at least strongly encouraged, to buy products that are significantly over-priced. They would have never even considered purchasing the product at the price being charged if it were not for the prospects of making money. They may even be encouraged to sell to relatives who are willing to support their business venture. The logic seems to be as follows: "Yes, the product is overpriced or unneeded. However, that does not matter. Buying these overpriced / unneeded products will more than makeup for any loss of money when others are influenced to purchase similar overpriced / unneeded products." Though perpetrators would never use these exact words, they are de facto saying, "If you let us rip you off, we will help you rip others off."

Some classic examples of these schemes have occurred in phone cards, web space, and discount shopping cards. People were recruited into selling 100 minute long-distance phone cards for $25. That amounts to $0.25 a minute. The only apparent reason that someone would pay that much for long distance is that it enables them to became part of a compensation plan. By purchasing phone cards at that price, the buyer gets compensated by getting others to do the same. The same thing happened with web space. People were recruited into paying as much as $200 per year for a one-page web site. It is unlikely that someone would pay that much money for so little space except that they would be compensated when they recruited others to do the same. Shopping discount cards are also attractive to companies that do not want to produce or move a legitimate product. For $50 a month, buyers can save ten to twenty percent at selected businesses. However, few people could possible spend enough money month after month to justify the $50 expense. The real attraction seems to be the possibility of making money without selling products.

In all three of these examples, the compensation supposedly came from the sale of products (phone cards, web space, or discount cards). However, the products were a nominal part of the whole process. People are not buying products because they see their inherent value. They are buying the products because they see the chance to make money or because they are helping a friend or family member make money.

So how can marketing educators help students differentiate opportunities that are selling legitimate products from those selling overpriced and unneeded products? They can do so by encouraging them to ask a simple question: "Would I buy a product such as this at the price that is being charged if it were not for the possibility of making money?" Another way to look at this is to ask the question, "Are people buying these products who are not doing so to make money?" What the student should do is unbundle the product from the opportunity. The opportunity is only legitimate if the products are legitimate apart from the opportunity. If the products do not offer value to consumers who have no interest whatsoever in making money from direct selling, then the opportunities should be avoided.

Note that this does not imply that the products need to be the lowest priced products on the market. Few multilevel marketing opportunities can consistently compete with that market position. The point was made earlier that multilevel marketing seems to fit a niche in the market for products that are either technologically advanced or have features that require significant explanation. Generally, such cases are not low priced products. They are usually more expensive products offering unique benefits to consumers. The question is not whether they are the lowest priced products, but rather whether they are of sufficient value to justify the price.

Question 3: How Much Does It Cost to Be Involved?

In theory, it should not cost much to become involved with a direct selling organization. The more money required to be involved, the higher the chances that money is primarily made from recruiting and not from the movement of products. There are three types of costs a person must consider when evaluating a multilevel marketing opportunity: registration, inventory, and training.

Almost all direct selling organizations require a registration fee to get involved. This fee covers the cost of maintaining an account and the necessary literature to get started. Because a high registration fee sends up a red flag to both regulators and prospects, registration fees are typically low. Even organizations that are ethically questionable tend to have low registration fees. They try to get their money though other means.

As mentioned earlier, one way to make money from recruiting is through inventory loading. This is highly unethical. All legitimate direct selling organizations have policies which prevent this practice. On the other hand, some unethical companies have policies which actually encourage inventory loading. They seem to want to sell as much as possible to new recruits through having very expensive package deals. By buying thousands of dollars of inventory, the new distributor can get special price breaks on products. Sometimes these are tied into special bonuses also. The new distributor may be able to make a few hundred dollars extra by spending thousands of dollars. Students should be advised to avoid companies that encourage the purchase of huge quantities of inventory up front. The up-front inventory level should be consistent with how much a new (not experienced) representative realistically could be expected to sell.

One other cost to be considered is training. Some companies charge fees for training events and materials. That is expected. As mentioned earlier, multilevel marketing participants are almost always independent contractors. If they were employees, they might reasonably expect their employers to pay for their training. Getting students to take financial responsibility for their own training helps them transition from an employee mindset to that of an entrepreneur.

It is important to consider what students should be taught about these training systems? Much of the material a student may get from these training systems can be extremely useful. In fact, there are many things that can come out of these training programs that can be very positive for students wishing to develop into business leaders (see Bhattacharya and Mehta 2000; Pratt 2000; Pratt and Rosa 2003). Students must evaluate the value of the training system. To do so, they may have to attend—and pay for—a training seminar, even before they become part of the opportunity. Doing so encourages students to think like businesspeople where information is valuable and often must be purchased.

Question 4: How Much Work Is Required?

Most college students experience these two conditions: they are short on money and they are short on time. Students are often looking for ways to increase their money that will not take much time, which makes them easy targets for get-rich-quick schemes. They show up at a meeting where a lot of people are excited. A well dressed person shows up in a nice car and promises them that they can make a lot of money real quick with little work. The student looks at the peripheral cues (the clothing and the car) and concludes that the speaker is credible. The crowd causes the social proof phenomenon to operate (see Cialdini 1998). All external signs are there. The student may start thinking, "Mom and Dad were wrong. I can get something for nothing. They just didn't find this once in a lifetime opportunity."

The ironic part is that legitimate direct selling opportunities that use multilevel compensation plans are the antithesis of the get-rich-quick mentality. People who have developed long-term income this way have built this income slowly. Eventually, a direct selling business may generate a very large income but only after significant up-front work has been done. If students are looking for immediate money, they should get a job. Only those students with the entrepreneur mentality who are willing to do the work of slowly developing clients and teams of independent sales representatives are going to succeed in direct sales.

All firms recruiting for a direct selling opportunity will emphasize the money that can be made. They will focus on the upside potential. They will use examples of highly successful representatives. To expect them to do otherwise is to expect them to do the opposite of what every other business in the world does—highlight their products and services in a positive light. Legitimate direct selling recruiters will put a positive spin on what they are doing, maybe even to the point of embellishment. However, there is a difference between product puffery and outright misrepresentation. A good cue that the line has been crossed is when the recruiters are talking in terms of fast money or easy money. Money made in direct selling is neither. It takes work and time to build a highly profitable direct selling business that will last. If a student is being recruited by someone who says otherwise, that should be taken as a red flag that something is not right.

Question 5: How Long Has the Company Been Around?

The fifth and final question a student should ask when being recruited is, "How long has the direct selling company been in business?" There is a myth that floats around that the best companies to get involved with are the new ones. This is the "ground-floor opportunity" myth. It goes something like this:

> If you had gotten in Amway when it first started, you would be rich. If you had gotten in Mary Kay when it first started, you would be rich. If you had gotten in... The people who make money are the ones who get in on the ground floor. Well, here is your chance to get in on the ground floor.

Actually, there were a lot of people who got in Amway, Mary Kay, and every other multilevel business opportunity early who are not rich and the vast majority of people who earn significant incomes from major direct selling firms did not get in on the "ground floor." Dexter Yeager, the number one income producer in the history of Amway got in five years after it started and Bill Britt who is number two got in seven years after that. At one point Paul Orbison was making a multiple seven-figure income with a giant telecommunication direct selling company. However, almost 1,000 people became involved with the company before he did. If the secret was simply to "get in early" then why did not all these other hundreds and hundreds of other people get rich, too?

If a company is a legitimate direct selling company, a new recruit should be able to make money regardless of when he or she becomes involved. As Vander Nat and Keep (2002) warn, "The probability of success for new entrants in a pyramid scheme decreases with the size of the pyramid regardless of the actions taken (or not) by individual participants" (p. 141). Is it ethical to recruit people who need to get in on the ground floor to make money? That means the quality of the opportunity diminishes over time and the person I am recruiting has a smaller chance of being successful than I do. A person is ill-advised to get involved with an opportunity where the newness of the company is a primary selling point.

Beyond ethical considerations, there is a practical concern to consider when deciding whether or not to get involved with a "ground floor opportunity." Hundreds upon hundreds of direct selling firms get started every year. Very few make it. As mentioned earlier, it takes time and work to build a direct selling business. Students should give serious consideration as to whether they want to involve themselves with a company that has yet to prove it will make it. If someone wants to work as hard as it takes to build a direct selling business, it is less risky to do so with a company that has been around for years. The chances of the firm being around for years to come are much higher. Of course, the issue is not that anything is unethical about being a new company. In fact, if all other aspects of the business are sound (i.e., good products, a solid leadership team, etc.), then it may be a great opportunity. However, it is ethically questionable to purport that a new multilevel opportunity is somehow superior to ones that have been around long enough to prove their viability. New opportunities should at least be presented for what they are: high-risk ventures perhaps with the potential for high returns.

Conclusion

In this article, several ethical and legal issues were discussed which involve multilevel marketing. Because so many potential ethical problems exist in this industry, educators may be tempted to advise students to avoid multilevel marketing all together. Is that really what should be done? Should students be told to skip the process of identifying and evaluating ethical issues in marketing settings? Should students be taught to replace this process of ethical evaluation with the "they're all crooks" heuristic?

To the contrary, direct selling provides a great framework for the classroom within which to evaluate ethical issues in marketing. If one were to systematically look at the ethical issues in any other area of marketing, they may be as plentiful as they are in direct selling. Any field that our students go into will have ethical issues they must be able to identify and evaluate. Marketing educators should be teaching students how to evaluate such ethical situations through real life examples such as direct selling. If the best heuristic marketing educators can give students is "they're all crooks," then they are not adequately teaching students how to successfully navigate the minefield of marketing ethics.

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